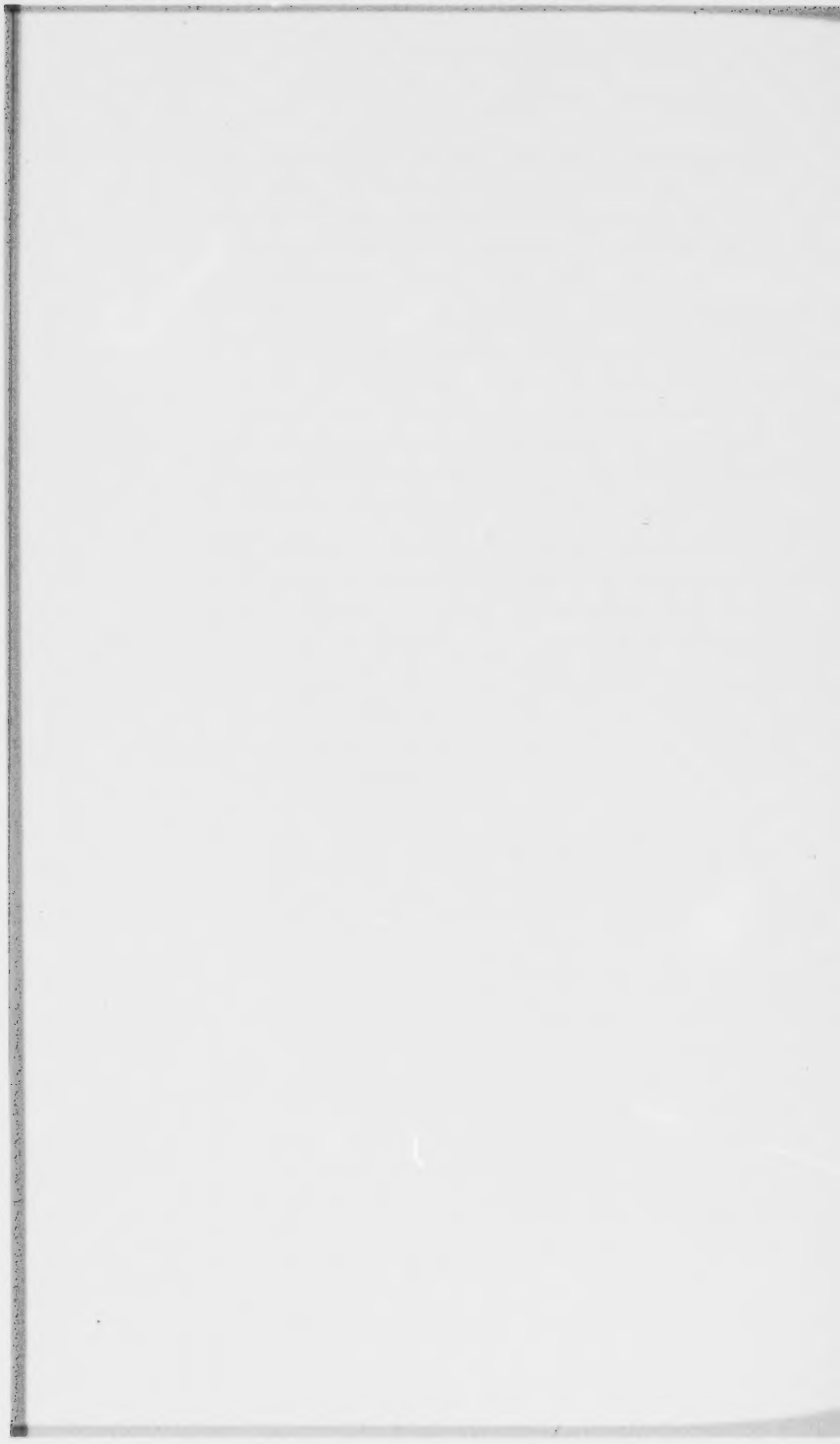

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In the Supreme Court of the United States

OCTOBER TERM—1940.

No. 764.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

THE CLEVELAND TRUST COMPANY,
Trustee of the Trust Estate known as
Garfield Building Site Trust,
Respondent.

On Petition for Writ of Certiorari
To The United States Circuit Court of Appeals
For the Sixth Circuit.

BRIEF OF RESPONDENT IN OPPOSITION.

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INDEX.

Statement 1

Summary of Argument Against Issuance of Writ 2

Argument 2

1. There is no conflict between the decision of the court below and the decision of the Circuit Court of Appeals for the Ninth Circuit in Title Insurance & Trust Company vs. Commissioner, 100 Fed. (2d) 482 3

2. The decision of the court below is not in conflict with the decision of this Court in Swanson vs. Commissioner, 296 U. S. 362, but properly applies the principles there established 6

3. The question here presented is not one of general importance but involves only the application of principles recently established by this Court to a specific type of real estate financing 7

Conclusion 9

Table of Cases.

Crocker vs. Malley, 249 U. S. 223 2

Hecht vs. Malley, 265 U. S. 144 2

Helvering vs. Coleman-Gilbert Associates, 296 U. S. 369 2

Helvering vs. Combs, 296 U. S. 365 2

Helvering vs. F. & R. Lazarus & Company, 308 U. S. 252 .....1, 4, 5, 6, 7, 9

Morrissey vs. Commissioner, 296 U. S. 344 .....2, 4, 9

Swanson vs. Commissioner, 296 U. S. 362 .....2, 3, 6, 7

Title Insurance & Trust Company vs. Commissioner, 100 Fed. (2d) 482 .....2, 3, 4, 5, 6, 8

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STATEMENT.

The question presented and the facts involved are correctly set forth in the petition for the writ.

In essence the facts disclose that the respondent is the trustee of a trust created as an integral part of an issue of land trust certificates in the ordinary form. The arrangement is similar in all respects to that recently considered by this Court in *Helvering vs. F. & R. Lazarus & Company,* 308 U. S. 252, in which the Court held that a land trust certificate issue is, for purposes of Federal income taxation, to be considered as the equivalent of a mortgage bond issue. The sole question is whether a trust created for so specific and limited a purpose is taxable as a trust or as an association.

SUMMARY OF ARGUMENT AGAINST ISSUANCE OF WRIT.

1. There is no conflict between the decision of the court below and the decision of the Circuit Court of Appeals for the Ninth Circuit in *Title Insurance & Trust Company vs. Commissioner,* 100 Fed. (2d) 482.

2. The decision of the court below is not in conflict with the decision of this Court in *Swanson vs. Commissioner,* 296 U. S. 362, but properly applies the principles there established.

3. The question here presented is not one of general importance but involves only the application of principles recently established by this Court to a specific type of real estate financing.

ARGUMENT.

Since 1913 this Court has on various occasions considered the characteristics which distinguish a strict trust from the type of entity which, although in the trust form, is subject to Federal income taxation as an association. After passing through two stages, represented by the decisions of this Court in *Crocker vs. Malley,* 249 U. S. 223, and *Hecht vs. Malley,* 265 U. S. 144, the general question was again considered and finally determined in a group of cases decided December 16, 1935. *Morrissey vs. Commissioner,* 296 U. S. 344; *Swanson vs. Commissioner,* 296 U. S. 362; *Helvering vs. Combs,* 296 U. S. 365; *Helvering vs. Coleman-Gilbert Associates,* 296 U. S. 369.

In these cases, this Court stated that it was impossible "in the nature of things to translate the statutory concept of 'association' into a particularity of detail that would fix the status of every sort of enterprise or organization which ingenuity may create." Nevertheless, the Court found the need of further examination of the question and adopted the fundamental test that before an association can exist there must be the entering into of a joint enterprise for the transaction of business. Throughout the

opinion, references to this fundamental requirement of "carrying on a business enterprise" occur. The Court carefully distinguished between two fundamentally different types of organization: the association, the object of which is to provide a medium for the conduct of a business and the sharing of its gains, and the trust, the object of which is to hold and conserve particular property, with incidental powers.

Since the decision in these cases, the courts have uniformly applied the principles therein enunciated and have considered the law as settled. The court below in its decision recognized and applied these principles and held that the nature and purpose of the trust here involved was foreign to any concept of carrying on business for profit and the sharing of its gains, and, therefore, properly determined that the trust was taxable as a trust.

In support of its petition for a writ of certiorari, the petitioner contends that the decision below is in conflict with *Title Insurance & Trust Company vs. Commissioner, supra,* that the decision below is in substantial conflict with the decision of this Court in *Swanson vs. Commissioner, supra,* and that the question here presented is one of general importance. It is submitted that a consideration of the reasons thus advanced by the petitioner indicates no basis for the granting of certiorari.

1. There is no conflict between the decision of the court below and the decision of the Circuit Court of Appeals for the Ninth Circuit in Title Insurance & Trust Company vs. Commissioner, 100 Fed. (2d) 482.

While it is true that *Title Insurance & Trust Company vs. Commissioner, supra,* involved a trust which was on its face rather similar to that here involved, that decision is clearly distinguishable. In that case, at the time the trust was created, *the property was not subject to any outstanding lease.* The trustee was authorized, but not required,

to lease the trust property or any part of it to a named corporation for a stated rental and to grant to the lessee an option to purchase the property. In the *Title Insurance & Trust Company* case the court stated (page 485):

> "In *Crocker vs. Malley*, 249 U. S. 223, 39 S. Ct. 270, 63 L. Ed. 573, 2 A. L. R. 1601, cited by petitioner, the function of the trustees was simply to collect the rents and income of the trust property. In this case, the function of the trustee was not so limited. Here, the trustee was empowered to lease the whole or any part of the trust property and, in 1927, did lease the whole of it to Sun Realty Company."

The decision of the court thus provides the fundamental distinction between that case and the one here presented, *where the property, when conveyed to the trustees, was already subject to a ninety-nine year lease and the lease was expressly made a part of the trust agreement by reference.* In the present case, at the time of the creation of the trust, the outstanding lease restricted the trustee in its powers and authorities as effectively as though its activities had been limited to the collection and disbursement of rentals by an express provision contained in the declaration of trust. This distinction is of vital importance in view of the test laid down by this Court in *Morrissey vs. Commissioner, supra,* which emphasized throughout the opinion that entering into a "business enterprise" is an essential characteristic of an association.

Whether the Circuit Court of Appeals for the Ninth Circuit should have taken so technical a view of the financing plan involved in *Title Insurance & Trust Company vs. Commissioner, supra,* is debatable, but it is unnecessary to consider that question in view of the clear basis of distinction which the court itself provides.

It is important to point out, moreover, that the *Title Insurance & Trust Company* case has lost its force as a precedent by the subsequent decision of this Court in *Helvering vs. F. & R. Lazarus & Company,* 308 U. S. 252.

The *Title Insurance & Trust Company* case was decided over two years ago, on December 27, 1938. On December 4, 1939, this Court entered its opinion in the *Lazarus* case, which involved the question of whether the lessee of property, which was the subject of land trust certificate financing of the type here presented, was entitled to deduct depreciation upon buildings located on the land. This Court held that such financing arrangements are to be considered as equitable mortgages for purposes of the Federal income tax. The basis for the decision is apparent from the following quotation from the opinion (page 255):

> "We think the Board justifiably concluded from its findings that the transaction between the taxpayer and the trustee bank, in written form a transfer of ownership with a lease back, was actually a loan secured by the property involved. General recognition has been given the 'established doctrine that a court of equity will treat a deed, absolute in form, as a mortgage, when it is executed as security for a loan of money.' In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding. Congress has specifically emphasized the equitable nature of proceedings before the Board of Tax Appeals by requiring the Board to act 'in accordance with the rules of evidence applicable in courts of equity of the District of Columbia.' 26 U. S. C. 611."

This decision, as applied to the case here under consideration, would indicate that, for income tax purposes, the lessee corporation is to be regarded as the owner of the property, and the trustee is to be regarded as occupying the same position as a trustee under a bond issue. Completing the analogy, the beneficiaries of the trust are to be regarded as bondholders, and the essential nature of the land trust certificate plan of financing is to be regarded as a substitute for a mortgage bond issue. Thus considered, there is no real venture or "business enterprise," which is a pre-requisite for the taxation of a trust as an

association. As the court below stated, there is no body of persons acting together in the prosecution of a business enterprise for profit.

An examination of the briefs filed in the *Title Insurance & Trust Company* case discloses that this point was not brought to the attention of the court. Certain it is that the Circuit Court of Appeals for the Ninth Circuit did not have the benefit of the subsequent decision of this Court in the *Lazarus* case.

It would appear that the decision of the Circuit Court of Appeals for the Ninth Circuit in the *Title Insurance & Trust Company* case is no longer of importance as an authority in view of the Supreme Court's subsequent decision in the *Lazarus* case. Accordingly any possible conflict between the two decisions is not of sufficient importance to deserve the further attention of this Court, whose prior decisions have so clearly confirmed the correctness of the decision below.

2. The decision of the court below is not in conflict with the decision of this Court in Swanson vs. Commissioner, 296 U. S. 362, but properly applies the principles there established.

The petitioner also urges that the decision below is in substantial conflict with the decision of this Court in *Swanson vs. Commissioner, supra.* While it is difficult to discuss this decision and at the same time avoid a consideration of the merits, it should be observed that the only vital point of resemblance to which the petitioner alludes is the fact that in both cases the property held consisted of a single parcel of real estate. In the *Swanson* case, vacant land had been acquired by two individuals with the view of improving it by the erection of an apartment house. After the apartment house had been constructed, the property was, at the suggestion of the owners' attorney, conveyed to trustees who issued receipts to evidence the interests of

the beneficiaries, representing 1,000 shares at the par value of $100.00 each. These shares were issued to the two owners of the land, who later transferred them to their wives. The agreement there clearly contemplated the continuance by the trustee of a business enterprise theretofore carried on by the creators of the trust. The petitioner implies in his brief that the court below, in concluding that there was present no plan to carry on a business, relied upon the fact that a single building was involved. That implication is not warranted by the court's opinion, which clearly points out that the whole plan and purpose of land trust financing are alien to the accepted concept of a business enterprise for profit.

The opinion of the court below is not, therefore, in conflict with the decision of this Court in *Swanson vs. Commissioner.* On the contrary, the decision expressly recognized and followed the principles established in the *Swanson* case (R. 115) and applied those principles to an arrangement which this Court had theretofore analyzed for income tax purposes in the *Lazarus* decision.

3. The question here presented is not one of general importance but involves only the application of principles recently established by this Court to a specific type of real estate financing.

The petitioner also contends that the question presented is one of general importance. As indicated in the petitioner's brief, this type of financing was probably employed most extensively in Ohio where the confiscatory taxation of real estate and mortgages under former Ohio laws gave added impetus to its use. The Revenue Agent's report tentatively proposing a deficiency in the present case was dated December 17, 1936. (R. 8.) Although over four years have now elapsed, an investigation at the three large Cleveland trust companies (corporate trustees almost invariably acted as trustees under the land trust issues) dis-

closes only three pending cases, in addition to this one, which involve the taxation of such trusts as associations. The deficiencies in tax ordinarily in issue when such an attempt is made are small. The size of the deficiency in the present case is small, but is larger than usual because of the fact that the trustee received a large amount of income upon a settlement with the defaulting lessee. (R. 16.) If the question of general importance is to be gauged by such tests, the question here presented is more properly characterized as one of infrequent occurrence, involving unimportant deficiencies, and of less general interest than the ordinary income tax question.

Moreover, the history of the treatment of such trusts by the Treasury Department is of interest in considering the general importance of the question. As early as March 10, 1925, the Solicitor of the Treasury Department ruled in an unreported decision (S. M. 3206), in answer to an inquiry by the trustee of a similar trust, that such a trust was to be taxed as a strict trust and not as an association. Thereafter, the same conclusion was reached in a ruling published in the bulletin service in 1928 as G. C. M. 1940-VII-1 C. B. 46. Until the question was raised in the present case and in the *Title Insurance & Trust Company* case, it is believed that the Department consistently followed its early decisions. In view of this uniform treatment, which accords with the conclusion reached by the court below, and in view of the relatively few instances in which the question has arisen in a city which is generally regarded as the home of land trust certificate financing, it would seem that the question presented is not one of general importance.

CONCLUSION.

The foregoing discussion indicates an absence of any conflict between the decision below and cases decided by this Court or by any Circuit Court of Appeals. The question is one calling only for the application of principles recently established by this Court in *Morrissey vs. Commissioner, supra,* and other cases decided the same day, and in *Helvering vs. F. & M. Lazarus & Co., supra.* The principles there laid down are not questioned, limited, or misinterpreted by the court below but were reiterated and properly applied to the facts presented.

It is, therefore, respectfully submitted that the petition for a writ of certiorari should be denied.

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